

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Person to Contact: [REDACTED]

Telephone Number: [REDACTED]

Refer Reply to: [REDACTED]

Date:

DEC 27 1994

Employer Identification Number: [REDACTED]

Key District: [REDACTED]

Dear Applicant:

We have considered your application for recognition of exemption as an organization described in section 501(c)(3) of the Internal Revenue Code. Based on the information submitted, we have concluded that you do not qualify for exemption under that section.

FACTS

You were formed on [REDACTED], pursuant to the [REDACTED] Corporation Law. On [REDACTED], you submitted your application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code on [REDACTED]. You also requested status as other than a private foundation under section 509(a)(3) of the Code. Your Amended and Restated Articles of Incorporation state that you shall be operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of [REDACTED] and any other exempt organizations controlled by or affiliated with [REDACTED] and that qualify for "public charity" status pursuant to section 509(a)(1) or section 509(a)(2) of the Code, or any future statute of similar import. You do not provide medical services. You make arrangements for the provision of medical services through the use of managed care concepts. You have represented that your goal is to increase access to quality health care in [REDACTED] County and the surrounding areas served by [REDACTED].

[REDACTED] is your sole member. A Board of Directors governs you. The Board is composed of [REDACTED] ex officio directors who serve by virtue of their service as officers of [REDACTED] and [REDACTED] appointed directors. One of the appointed directors is appointed by [REDACTED]'s Board of Directors. [REDACTED] directors are appointed by the Employer Advisory Committee.¹ Another director is appointed by a majority of the Board as representative of the consumers. A sixth appointed

¹ The Employer Advisory Committee consists of [REDACTED] members appointed by the applicant's President that have a subscription agreement with the applicant.

director is a primary care physician elected by the Physician Advisory Committee.² The seventh and eight appointed directors will be specialty care physicians appointed by the Physician Advisory Committee. Board members as well as the members of all advisory committees are not compensated for their services in those capacities.

Your primary activity is the implementation, coordination, and oversight of a managed health care delivery system and other planning activities for the system. These activities include the following:

1. Establishing and maintaining a network of primary care physicians (family practitioners, pediatricians, internists) and selected specialists (as well as a number of miscellaneous ancillary providers such as pharmacies) who will agree to offer their services at negotiated reduced rates and marketing that network to the health care payors of the [REDACTED] County, [REDACTED] area. You also make arrangements for the provision of hospital care at several hospitals including [REDACTED].
2. Credentialing all providers and prospective providers based upon eligibility standards established by you. Medical credentialing activities typically involve an examination of a prospective physician's education and board credentials, utilization patterns, history of malpractice, if any, and the like.
3. Establishing and maintaining service and quality standards, which will also involve monitoring and supporting cost-effective medical service protocols and outcomes as delivered by network providers.
4. Establishing and maintaining primary care management guidelines and other measures to ensure the efficient and cost-effective delivery of medical care by the network providers.
5. Establishing and maintaining a provider problem resolution procedure to resolve disputes between providers and patients.

² Members of the Physician Advisory Committee are appointed by the applicant's President from among the physicians that have a subscription agreement with the applicant.

6. Working with providers, employers, and insurers to determine the best method of integrating the applicant's services into the existing medical benefit programs of various [REDACTED] County area employers.

Your principal sources of financial support are subscriptions fees and contributions from your sole member, [REDACTED].

ANALYSIS

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations which are organized and operated exclusively for charitable or education purposes, no part of the net income of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purposes.

Section 1.501(a)-1(c) of the regulations provides that private shareholders or individuals are defined as persons having a personal and private interest in the activities of an organization.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. Thus, to meet the requirements of section 501(c)(3) of the Code, it is necessary for you to establish that you are not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 509(a)(3) of the Code provides that an organization that meets the following requirements is other than private foundation:

1. It is organized, and at all times thereafter is operated for the benefit of, or to carry out the purposes of one or more specified organizations described in sections 509(a)(1) and 170(b)(1)(A) of the Code other than in clauses (vii) and (viii), as well as in section 509(a)(2);

2. It is operated, supervised, or controlled by or in connection with one or more organizations described in sections 509(a)(1) and 170(b)(1)(A) other than in clauses (vii) and (viii), as well as in section 509(a)(2); and
3. It is not controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more organizations described in sections 509(a)(1) and 170(b)(1)(A), as well as section 509(a)(2).

Section 1.509(a)-4(c)(1) of the regulations provides that in order for an organization to be organized exclusively for one or more of the purposes of section 509(a)(3) of the Code its articles of organization:

- (i) Must limit the purposes to one or more of the purposes set forth in section 509(a)(3)(A);
- (ii) Do not expressly empower the organization to engage in activities which are not in furtherance of the purposes referred to in subdivision (i) of this paragraph;
- (iii) State the specified publicly supported organizations on whose behalf such organization is to be operated;
- (iv) Do not expressly empower the organization to operate to support or benefit any organization other than the specified publicly supported organizations referred to in subdivision (iii) of this subparagraph.

Section 1.509(a)(3)-4(e) of the regulations provides that a supporting organization will be regarded as "operated exclusively" to support one or more specified publicly supported organizations only if it engages in activities which support or benefit the specified publicly supported organizations. An organization may satisfy this test by using its income to carry on an independent activity or program that which supports or benefits the specified publicly supported organizations.

Section 1.509(a)(3)-4(f)(2) of the regulations provides that section 509(a)(3)(B) of the Code may be satisfied by three different types of relationships that will justify classification of an organization as a supporting organization:

- (i) Operated, supervised, or controlled by,

- (ii) Supervised or controlled in connection with, or
- (iii) Operated in connection with, one or more publicly supported organizations.

Section 1.509(a)(3)-4(f)(3) requires that any of the above relationships insure that:

- (i) The supporting organization will be responsive to the needs or demands of one or more publicly supported organizations; and the supporting organization will constitute an integral part of, or maintain a significant involvement in, the operations of one or more publicly supported organizations.

Rev. Rul. 69-545, 1969-2 C.B. 117, establishes the "community benefit standard" which focuses on a number of factors indicating the operation of a hospital benefits the community rather than serving private interests. The revenue ruling requires all relevant facts and circumstances to be weighed in each case. The facts in Situation 1 of the revenue ruling indicate that the hospital is controlled by a board composed of independent civic leaders, it has an open medical staff, and an active, open, and accessible emergency room. Therefore, the hospital operates to serve public rather than private interests. In Situation 2 of the revenue ruling, five doctors who owned a for-profit hospital sold at fair market value their interest in the hospital to a nonprofit hospital which they controlled. The new nonprofit hospital is not exempt because of excessive private benefit to the five doctors. The facts indicate that in five years of operation only four other doctors have been granted staff privileges, applications from qualified physicians in the community have been rejected, admissions are restricted to patients of doctors holding staff privileges, the emergency room does not demonstrate a commitment to charity care and the physicians maintain office space at less than fair market value. This revenue ruling establishes a "facts and circumstances test" to measure private versus public benefit.

The private benefit prohibition of section 501(c)(3) applies to all kinds of persons and groups, not just to those "insiders" subject to the more strict inurement proscription. Prohibited private benefit may include an "advantage; profit; fruit; privilege; gain or interest." Retired Teachers Legal Defense Fund v. Commissioner, 78 T.C. 280, 286 (1982).

Rev. Rul. 78-41, 1978-1 C.B. 148, holds that a trust created by an exempt hospital for the sole purpose of accumulating and holding funds to be used to satisfy malpractice claims against the

hospital and from which the hospital directs the bank trustees to make payments to claimants qualifies for exemption under section 501(c)(3) of the Code. By serving as a repository for funds paid in by the hospital, and by making payments at the direction of the hospital to persons with malpractice claims against the hospital, the trust is operating as an integral part of the hospital. The trust is performing a function that the hospital could do directly.

An organization may provide benefits to private individuals provided those benefits are incidental quantitatively and qualitatively. To be qualitatively incidental, private benefit must be a necessary concomitant of an activity which benefits the public at large; in other words, the benefit to the public cannot be achieved without necessarily benefitting certain private individuals. To be quantitatively incidental, the private benefit must be insubstantial, measured in the context of the overall public benefit conferred by the activity. To illustrate the quantitatively incidental concept, compare Rev. Rul. 68-14, 1968-1 C.B., with Rev. Rul. 75-286, 1975-2 C.B. 210. In Rev. Rul. 68-14, an organization that helped beautify a city was exempt when it planted trees in public areas, cooperated with municipal authorities in tree plantings and programs to keep the city clean, and educated the public in advantages of tree planting. In Rev. Rul. 75-286, an organization with similar activities did not qualify under section 501(c)(3) where its members consisted of residents and business operators of a city block and its activities were limited to that block. The facts in Rev. Rul. 75-286 indicate that the organization was organized and operated for the benefit of private interests by enhancing the value of members' property.

The facts submitted indicate you are not engaging in the practice of medicine or operating a hospital. You are merely negotiating managed care and physician care contracts for physicians in private practice, which is not a charitable activity because it serves the private interests of the physicians in conducting their private medical practices, as well as the private interests of pharmacies and other for profit-providers that participate in your network.

In addition, your implementation, coordination, and oversight of a managed health care delivery system, as well as other planning activities, only indirectly benefit the community as a whole. These planning activities are primarily beneficial to the private physicians because you are providing the physicians with specific long and short term planning information which can be used by them in their private business activities. Therefore, the private benefit to the physicians is not qualitatively or quantitatively incidental or insubstantial in comparison to the community benefit produced by your activities.

You do not qualify under section 501(c)(3) of the Code as an integral part of your exempt parent. First, to be an integral part of an exempt parent your activities must be ones that would not be an unrelated trade or business if performed by the parent. Arranging for the provision of health care is an unrelated trade or business. See Geisinger Health Plan v. Comm., 100 T.C. No. 26, (1993). Although you are a subsidiary of [REDACTED], to be exempt as an integral part of your exempt parent you must provide essential services solely to your exempt parent and the parent's exempt subsidiaries. Because you negotiate managed care contracts with physicians and other providers, you do not satisfy this requirement.

The physicians under the facts submitted are "private individuals" and are subject to the private benefit proscription. The physicians receive prohibited private benefit which includes an advantage, profit, fruit, privilege, gain and interest through their transactions with you. See Retired Teachers Legal Defense Fund v. Commissioner, *supra*. The substantial private benefit to the physicians and other providers is fatal to your exempt status. Furthermore, since the physicians have representation on our Board of Directors, the physicians on your Board are "insiders" subject to the inurement proscription.

Based on all the facts and circumstances, the Service must conclude that you do not perform a charitable activity, you are not an integral part of an exempt parent, and more than insubstantially you benefit the private interests of the physicians, some of whom receive prohibited inurement. See Better Business Bureau v. United States, 326 United States 278 (1945).

Lastly, we conclude that since you are not providing services exclusively to your exempt parent or services that could be carried out by your exempt parent as part of its exempt charitable functions, you do not qualify as a supporting organization under section 509(a)(3) of the Code.

For all the reasons stated above, we have concluded that you do not qualify for exemption from Federal income tax under section 501(c)(3) of the Code and you are required to file Federal income tax returns. Contributions to you are not deductible under section 170 of the Code.

You have the right to protest this ruling if you believe that it is incorrect. To protest, you should submit a statement of your views, with a full explanation of your reasoning. This statement must be submitted within 30 days of the date of this letter and must be signed by one of your officers. You also have a right to a conference in this office after your statement is submitted. If

you want a conference, you must request it when you file your protest statement. If you are to be represented by someone who is not one of your officers, he/she must file a proper power of attorney and otherwise qualify under our Conference and Practice Requirements.

If you do not protest this proposed ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgment or decree under this section shall not be issued in any proceeding unless the United States Tax Court, the United States Court of Federal Court, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and copies will be forwarded to your key District Director. Thereafter, if you have any questions about your federal income tax status, including questions concerning reporting requirements, please contact your key District Director.

Sincerely,

(signed) [REDACTED]

[REDACTED]
Chief, Exempt Organizations
Technical Branch 1

CC: [REDACTED]
[REDACTED]